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Winning through Merger and Acquisition

Buyers and sellers can create a lot of value through merger and acquisition (M&A). Both can win from a transaction. That is the beauty of dealmaking. And that is much of the allure that has driven the tremendous volume of M&A activity in the United States during the 1990s; in recent years this trend has extended worldwide.[1]

This book focuses on business value—what creates it, how to measure it, how to build it, and how to maximize it in merger and acquisition. These concepts are equally important to buyers and sellers because both can and should benefit from a deal. But different results frequently occur. Sellers may sell under adverse conditions or accept too low a price due to lack of preparation or knowledge. And every buyer runs the risk of purchasing the wrong business or paying too much. That is why understanding value—and what drives it—is critical in merger and acquisition.

Wise shareholders and managers do not, however, confine their focus on value to only M&A. Value creation drives their strategic planning and, in the process, creates focus and direction for their company. Their M&A strategy supports and complements their broader goal of building shareholder value and they buy and sell only when the deal creates value for them.

[1] Chapter 5 presents a very necessary second view of the potential results of M&A.

This brings us back to the purpose of this book. It explains how to create, measure, and maximize value in merger and acquisition in the context of the broader business goal of building value. Senior managers in most public companies focus on value every day because it is reflected in the movement of their stock price—the daily scorecard of their performance relative to other investment choices. Private companies, however, lack this market feedback and direction. Their shareholders and executives seldom understand what their company is worth or clearly see what drives its value. For this reason, many private companies—and business segments of public companies as well—lack direction and underperform.

Managing the value of a private company, or a division of a public corporation, is particularly difficult because that value is harder to compute and justify. Yet most business activity—and value creation or destruction—occurs at this operational level.

Being able to accurately measure and manage the value of smaller businesses or business segments is critical in the value creation process. And this skill will pay off in M&A as well because most transactions involve smaller entities. Although we read and hear about the big deals that involve large corporations with known stock prices, the median M&A transaction size in the United States in recent years has been about $25 to $40 million. Smaller deals involving closely held companies or segments of public companies are the scene for most M&A activity.

Therefore, every value-minded shareholder and executive must strive to maximize value at this smaller-entity level where daily stock prices do not exist. The concepts and techniques that follow explain how to measure and manage value on a daily basis and particularly in M&A. The discussion begins with an understanding of what value is.

CRITICAL VALUES SHAREHOLDERS OVERLOOK

When buyers see a potential target, their analysis frequently begins by identifying and quantifying the synergies they could achieve through the acquisition. They prepare a model that forecasts the target's potential revenues if they owned it, the adjusted expense levels under their management, and the resulting income or cash flow that they anticipate. They then discount these future returns by their company's cost of capital to determine the target's value to them. Armed with this estimate of value, they begin negotiations aimed at a deal that is intended to create value.

If the target is not a public company with a known stock price, frequently no one even asks what the target is worth to its present owners. However, the value the business creates for the present owners is all that they really have to sell. Most, and sometimes all, of the potential synergies in the deal are created by the buyer, rather than the seller, so the buyer should not have to pay the seller for the value the buyer creates. But in the scenario just described, the buyer is likely to do so because his or her company does not know what the target is worth as a stand-alone business. Consequently, the buyer also does not know what the synergies created by his or her company through the acquisition are worth, or what the company's initial offer should be.

Sellers are frequently as uninformed or misinformed as buyers. Many times the owners of the target do not know if they should sell, how to find potential buyers, which buyers can afford to pay the most to acquire them, what they could do to maximize their sale value, or how to go about the sale process. After all, many sellers are involved in only one such transaction in their career. They seldom know what their company is currently worth as a stand-alone business, what value drivers or risk drivers most influence its value, or how much more, if any, it would be worth to a strategic buyer. Typically none of their team of traditional advisors—their controller, outside accountant, banker, or attorney—is an expert in business valuation. Few of these professionals understand what drives business value or the subtle distinction between the value of a company as a stand-alone business versus what it could be worth in the hands of a strategic buyer.

The seller could seek advice from an intermediary, most commonly an investment banker or business broker. But these advisors typically are paid a commission—if and only if they achieve a sale. Perhaps current owners could achieve a higher return by improving the business to position it to achieve a greater value before selling. This advice is seldom popular with intermediaries because it postpones or eliminates their commission.

With sound advice so hard to find, sellers frequently postpone sale considerations. Delay is often the easier emotional choice for many entrepreneurs who identify personally with their company. But with delay, opportunities are frequently lost. External factors, including economic, industry, and competitive conditions that may dramatically affect value, can change quickly. Consolidation trends, technological innovations, or regulatory and tax reforms also can expand or contract M&A opportunities and value.

Procrastination also can hamper estate planning and tax strategies because delays reduce options. And the bad consequences are particularly acute when value is rapidly increasing.

Thus, buyers and sellers have very strong incentives to understand value, manage what drives it, and track it to their mutual benefit.

STAND-ALONE FAIR MARKET VALUE

With a proper focus on maximizing shareholder value, buyers and sellers begin by computing the target company's stand-alone fair market value, the worth of what the sellers currently own. This value reflects the company's size, access to capital, depth and breadth of products and services, quality of management, market share and customer base, levels of liquidity and financial leverage, and overall profitability and cash flow as a stand-alone business.

With these characteristics in mind, *fair market value* is defined by Revenue Ruling 59–60 of the Internal Revenue Service as ". . . the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."

Fair market value includes the following assumptions:

- Buyers and sellers are hypothetical, typical of the market, and acting in their own self-interest.
- The hypothetical buyer is prudent but without synergistic benefit.

- The business will continue as a going concern and not be liquidated.
- The hypothetical sale will be for cash.
- The parties are able as well as willing.

The buyer under fair market value is considered to be a "financial" and not a "strategic" buyer. The buyer contributes only capital and management of equivalent competence to that of the current management. This excludes the buyer who, because of other business activities, brings some "value-added" benefits to the company that will enhance the company being valued and/or the buyer's other business activities, for example, being acquired by other companies in the same or a similar industry. Also excluded is the buyer who is already a shareholder, creditor, or related or controlled entity who might be willing to acquire the interest at an artificially high or low price due to considerations not typical of the motivation of the arm's-length financial buyer.

The seller in the fair market value process is also hypothetical and possesses knowledge of the relevant facts, including the influences on value exerted by the market, the company's risk and value drivers, and the degree of control and lack of marketability of that specific interest in the business.

Investment value is the value to a particular buyer based on that buyer's circumstances and investment requirements. This value includes the synergies or other advantages the strategic buyer anticipates will be created through the acquisition.

Fair market value should represent the minimum price that a financially motivated seller would accept because the seller, as the owner of the business, currently enjoys the benefits this value provides. The controlling shareholder in a privately held company frequently possesses substantial liquidity because he or she can harvest the cash flow the company generates or sell the company. The lack-of-control or minority shareholder generally possesses far less liquidity. As a result, the value of a lack-of-control interest is usually substantially less than that interest's proportionate ownership in the value of the business on a control basis.

Prospective buyers who have computed stand-alone fair market value should also recognize that this is the base value from which their negotiating position should begin. The maximum value the buyer expects to create from the deal is the excess of investment value over fair market value. So any premium the buyer pays above fair market value reduces the buyer's potential gain because the seller receives this portion of the value created.

Sellers frequently are motivated by nonfinancial considerations, such as their desire to pass ownership of the company on to their children, or, if they work in the company, to retire or do something else. When these nonfinancial considerations exist, it is particularly important for shareholders to understand the financial effect of decisions made for personal reasons. Opportunistic buyers can take advantage of sellers, particularly those who are in adverse personal circumstances. Once again, this fact stresses the need for a continual focus on value and implementation of a strategic planning process that routinely considers sale of the company as a viable option to maximize shareholder value. This process accommodates shareholders' nonfinancial goals and provides the time and structure to achieve them and manage value as well.

INVESTMENT VALUE TO STRATEGIC BUYERS

The investment value of a target is its value to a specific strategic buyer, recognizing that buyer's attributes and the synergies and other integrative benefits that can be achieved through the acquisition. Also known as strategic value, the target's investment value is probably different to each potential buyer because of the different synergies that each can create through the acquisition. For example, one buyer may have a distribution system, product line, or sales territory in which the target would fit better than with any other potential buyer. Generally this is the company to which the target is worth the most. Well-informed buyers and sellers determine these strategic advantages in advance and negotiate with this knowledge.

The difference between fair market value and investment value is portrayed in Exhibit 1-1, which shows an investment value for two potential buyers. The increase in investment value over the company's fair market value is most commonly referred to as a control premium, but this term is somewhat misleading. Although the typical buyer does acquire control of the target through the

Exhibit 1-1 Fair Market Value versus Investment Value

Investment Value – 2	______
Investment Value – 1	______
Acquisition Premium	
Fair Market Value	______

acquisition, the premium paid is generally to achieve the synergies that the combination will create. Thus, this premium is more accurately referred to as an acquisition premium because the primary force driving it is synergies, rather than control, which is only the authority necessary to activate the synergy.

The obvious questions this discussion generates are:

- Why should a buyer pay more than fair market value?
- If the buyer must pay an acquisition premium to make the acquisition, how much above fair market value should the buyer pay (i.e., how large should the acquisition premium be, either as a dollar amount or as a percentage of fair market value)?

Chapter 4 summarizes statistics that indicate that the mean and median acquisition premiums for purchases of public companies in the United States have been about 40% and 30%, respectively, over the last 10 years. These figures are not presented as a guideline or as a target. Premiums paid are based on competitive factors, consolidation trends, economies of scale, and buyer and seller motivations; facts that again emphasize the need to thoroughly understand value and industry trends before negotiations begin. For example, a company with a fair market value of $10 million has a much stronger bargaining position if its maximum investment value is $20 million than if it is only $12 million. To negotiate the best possible price, however, the seller should attempt to determine what its maximum investment value is, which potential buyer may have the capacity to pay the most in an acquisition, and what alternatives each buyer has, and then negotiate accordingly.

Generally speaking, buyers should begin their negotiations based on fair market value. Before they enter the negotiation process, where emotional factors and the desire to "do the deal" take over, buyers should establish their walk-away price. This is the maximum amount above fair market value that they are willing to pay to make the acquisition. Establishing the maximum price in advance encourages buyers to focus on value rather than on "winning" the deal. Naturally, the farther the price moves above fair market value toward that buyer's investment value, the less attractive the deal becomes. Value-oriented buyers recognize that acquisitions at a price close to their investment value require them to fully achieve almost all forecasted synergies—on time—to achieve the forecasted value. And the closer the acquisition price gets to their investment value, the less value the acquisition can create for the buyer's shareholders and the smaller the buyer's potential margin of error. When a seller demands too high a price, the buyer's better option is often to decline that deal and look for one with a better potential to create value.

This fact illustrates a fundamental but essential lesson in making any investment: *Identify the distinction between a good company and a good investment.* While a good company may possess many strengths, it will prove to be a bad investment if the price paid for it is too high. Conversely, a company with weaknesses may offer a good investment opportunity if the price is adequately low relative to the forecasted returns, particularly to the strategic buyer who possesses the strengths to compensate for the target's weaknesses.

"WIN-WIN" BENEFITS OF MERGER AND ACQUISITION

To illustrate the "win-win" benefits of M&A to buyers and sellers, the following discussion summarizes the valuation of Cardinal Publishing Company, which is presented in detail in Chapter 16. Many of the technical steps in this illustration are explained only briefly. Each step is described in detail in the chapters that follow. Various technical issues will be introduced in italicized print with a reference to the chapter that explains how to handle these matters.

Cardinal was founded about 10 years ago by Lou Bertin, who had enjoyed a successful career in advertising. Bertin believed that many people shared his love for the outdoors and simple country living and that they would subscribe to journals dedicated to this topic. Armed with his entrepreneurial spirit, substantial expertise in direct-mail advertising, $1.7 million of his and two 10% minority investors' equity cash, and a well-conceived business plan, he founded Cardinal. Following a folksy tone and style, combined with excellent photography, minimal advertising, attractive subscription rates, and creative direct mail promotions, Cardinal grew rapidly from concept to several specialized, profitable journals.

As with most emerging companies, however, several major risks and constraints weighed heavily on Bertin. He is looking to retire or at least reduce his hours. And although Cardinal is successful, Bertin has seen his personal wealth increasingly tied to the fate of the company at a time in his life when he knows diversification is the much wiser investment strategy. *Should Bertin's 80% equity interest in Cardinal be valued or some other investment? Would the valuation process or computation be different if he owned a 100% interest and there were no minority shareholders, or if all of the stock were owned by minority shareholders?* (See Chapter 12).

Sales for Cardinal's latest year top $75 million, and earnings before interest and taxes (EBIT) adjusted to reflect ongoing operations will be about $7.5 million. *Is EBIT the best measure of return for Cardinal? Would it be more accurate to use revenue or net income before or after taxes or cash flow?* (See Chapter 6). Cardinal is heavily leveraged. To move toward long-term stability, significant additional capital spending is required. *Does the financial leverage affect value, and if so, how?* (See Chapter 9). *Does the anticipated capital spending affect value and how do we account for it?* (See Chapter 6).

The company's product line is narrow by industry standards, although it has developed a loyal and rapidly growing base of affluent readers. Because of Cardinal's specialty nature, the company has a weak distribution system—completely reliant on general distributors—which complicated Bertin's efforts to add new products and attract more advertising. *How can the valuation reflect these various risk drivers and value drivers? What if the buyer can eliminate some of these weaknesses?* (See Chapters 3 and 8). Bertin's staff is comprised primarily of family members and outdoor enthusiasts, and Bertin himself has lost the enthusiasm for the strategic planning the company would need to continue its historical growth performance. *Should an adjustment be made if some of these individuals do not materially contribute to the success of the company? Should an adjustment be made if anyone is paid above or below market compensation?* (See Chapter 6).

Bertin has been routinely approached by business brokers and contacts within the publishing industry about a sale of the company, and he is especially concerned that in the last two years, several major publishers have launched new products aimed at his market. Although the new publications lack Cardinal's quality and creativity, they carry much better advertising and are available on newsstands and promoted through tear-out inserts in several national publications. This new competition has led Bertin to postpone planned price increases, and although he continues to look for additional advertising, he cannot attract the companies he seeks most. *Can these competitive issues be identified by reviewing Cardinal's financial statements? What additional research, if any, is required? How are these competitive factors reflected in the valuation?* (See Chapters 3 and 8).

Computation of Cardinal's Stand-Alone, Fair Market Value

As a small- to middle-market-size company, Cardinal carries many risks, including limited capital, high financial leverage, a narrow product line, poor distribution system, and very limited management. When combined with the company's loyal customer base, rapid sales growth, high product quality, and average profitability, these factors generate Cardinal's weighted average cost of capital rate of 18%, which reflects its risk profile and growth prospects. *Is a weighted average cost of capital the same as a discount rate? Is this the same as a capitalization rate?* (See Chapters 7 and 9). When the company's normalized net income to invested capital of $4.8 million for this year is divided by a 14% weighted average cost of capital (WACC) capitalization rate, the fair market value on a stand-alone basis of the enterprise is determined to be $36 million. *Is this the value of equity?* (See Chapter 6). *Why is only 1 year of earnings used to compute value? How does this reflect future year growth?* (See Chapter 7).

Investment Value to Strategic Buyer

The larger public company that wants to quickly acquire a presence in this new "country" market recognizes Cardinal's strengths and weaknesses. Because the larger buyer frequently can eliminate many or all of Cardinal's limitations, it can increase Cardinal's sales growth and profits much more rapidly. Cardinal is also much less risky as a segment of the large company that possesses a broad array of market strengths. *How are these changes in risk reflected in the valuation? Who gets this value?* (See Chapter 3).

When owned by the strategic buyer, Cardinal's stand-alone EBIT could be increased over the next several years through more efficient operations and access to a broader market and an extensive distribution system. In the terminal period following the forecast, Cardinal's growth should be similar to that of the publishing industry. *How should the forecast and the years thereafter be used in computing value?* (See Chapter 7).

While Cardinal has a WACC capitalization rate of 18%, Omni Publications, the buyer, a large, well-known public company, has a WACC discount rate of about 12%. *How are cap rates and discount rates different, and when should each be used?* (See Chapters 7, 8 and 9). Because Cardinal operates in a new market for this buyer, has limited management, and increasing competition, the buyer adjusted its discount rate for the added risk of Cardinal. *Should the buyer use its own discount rate to compute the investment value of Cardinal? If not, how should it be adjusted? How should this rate be affected by Cardinal's high financial leverage?* (See Chapter 9). The multiple period discounting of Cardinal's forecasted net cash flow to invested capital adjusted for synergies determined that Cardinal's invested capital is worth $50 million to one strategic buyer. *What is net cash flow to invested capital, how is it computed, and how many years should be discretely forecasted?* (See Chapter 6). *How does this discounting process reflect the potential adjustments to the return and the rate of return for the risk drivers and value drivers that have been considered?* (See Chapters 7 and 8). The $15 million excess of the $50 million investment value of invested capital over Cardinal's $35 million fair market value means this buyer could pay up to $15 million over stand-alone fair market value to acquire Cardinal. *What should be the minimum value considered by both the buyer and the seller to start the negotiations? How much above $35 million should this buyer be willing to* *pay to acquire Cardinal? Should this decision be influenced by competitors also bidding to acquire Cardinal? If the buyer pays $50 million to acquire Cardinal, is the buyer better off? How?* (See Chapters 1, 4, and 5).

Cardinal's balance sheet shows assets of almost $44 million and equity of $15 million. *How do these affect its value?* (See Chapters 11 and 12). Public companies in Cardinal's industry are selling at EBIT multiples ranging from 3 to 18, with a mean of 8. *Should these be considered, and how? Do the EBIT multiples generate equity value?* (See Chapter 10). Another public publishing company recently sold for a 72% premium over its market value. *Should this transaction be considered in determining value.* (See Chapter 10).

Since Cardinal is not a public company, should there be a discount for lack of marketability? Since Cardinal has minority owners, is a control premium or lack-of-control discount needed? (See Chapter 13).

Can a buyer employ strategies to reduce risk in an acquisition? (See Chapters 4 and 16). *How can buyers most effectively evaluate synergies?* (See Chapter 5).

Can sellers employ a strategy to build value? Can they effectively plan in advance for a sale? (See Chapters 2 and 4).

Buyers and sellers clearly have opportunities to gain through merger and acquisition. In order to create value, however, they must be able to measure and manage it. This process begins with the ability to identify and quantify those factors that create value. Most often, this must be done in a privately held company or a division of a public corporation where stock prices do not exist. The following chapters explain how to build operating value in a private company and how to create, measure, and manage value in merger and acquisition.